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IN THE

Supreme Court of the United States

October Term, 1942.

No. 341

PACIFIC SOUTHWEST REALTY COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND SUPPORTING BRIEF.

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COMMISSIONER OF INTERNAL REVENUE,
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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT AND SUPPORTING BRIEF.

To the Honorable Supreme Court of the United States:

Pacific Southwest Realty Company, a corporation, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit entered in the above cause on June 8, 1942, affirming a decision of the United States Board of Tax Appeals.

Opinions Below.

The opinion of the United States Board of Tax Appeals [R. 37-65] is reported in 45 B. T. A. 426. The opinion of the Circuit Court of Appeals [R. 213-222] is reported in ..... F. (2d) .....

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on June 8, 1942. The jurisdiction of this court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (28 U. S. C. A. §347).

Statute Involved.

Section 23(b) Revenue Act of 1936:

"In computing net income there shall be allowed as deductions—

(a) * * *

(b) Interest. All interest paid or accrued within the taxable year on indebtedness, * * *"

Statement of Facts.

The action below is an appeal from a decision of the United States Board of Tax Appeals affirming determinations of respondent of deficiencies in income taxes against petitioner for the years 1936 and 1937.

Petitioner is a Delaware corporation with its principal place of business in the City of Los Angeles, California. [R. 137.] Petitioner was incorporated by persons affiliated with the Pacific Southwest Trust and Savings Bank and First National Bank of Los Angeles for the purpose of acquiring and thereafter owning and operating all the real estate properties owned by the Pacific Southwest Trust and Savings Bank and one parcel of real estate owned by the First National Bank of Los Angeles, and for the further purpose of providing additional bank premises as the growth of the banks required. [R. 137.] The

reason for the organization of petitioner was that the growth of the banks required additional investment in bank premises and in order not to lock up the funds of the bank in real estate used for bank premises it was deemed advisable to organize a subsidiary company to own the real estate and to employ outside capital for that purpose. [R. 137, 159.]

All of the common stock of petitioner was issued to First Securities Company, an affiliate of the above banks. [R. 138.]

During the years 1923, 1924 and 1925 petitioner issued and sold its securities designated 6½% Cumulative Preferred Serial Stock. [R. 138.] During the year 1928 petitioner issued and sold its securities designated 5½% Cumulative Preferred Serial Stock. [R. 140.] Said securities were issued in accordance with and pursuant to the authority granted by article fourth of petitioner's certificate of incorporation. [R. 138, 140.] A true copy of article fourth of the certificate of incorporation is attached to the stipulation of facts as Exhibit "A". [R. 146.] Each of said securities was issued in series. The first series (series A) of the 6½% Cumulative Preferred Serial Stock matured and became payable on July 1, 1929, and the remaining series were to mature and become payable successively on the first day of July of each year thereafter to and including the year 1951. [R. 138.] The first series of the 5½% Cumulative Preferred Serial Stock (series AA) was to mature and become payable on July 1, 1939, and the remaining series were to mature and become payable successively on July first of each year thereafter to and including the year 1960. [R. 140.] The maturity dates of each series of said securities were set

forth in the certificate of incorporation and the maturity date of each security was stated on the face of the certificate issued. [R. 157, 191.]

Said securities provided for the payment to the holders thereof of so-called dividends in the amount of 6½% per annum and 5½% per annum, respectively. The so-called dividends were to be paid out of surplus or net profits prior to the maturity of the securities, but upon maturity or prior liquidation petitioner was required to pay any accumulated unpaid "dividends", as well as the principal sum, out of general assets, if necessary, the same as any claim or debt against the corporation. [R. 153, 187.] The holders of said securities had no right to participate in earnings or profits in addition to the specified fixed "dividends". [R. 157, 192.]

It was provided in the certificate of incorporation and on the face of the certificates issued that upon the maturity date specified each series of said securities "shall be redeemed at par plus unpaid, accrued and accumulated dividends thereon." [R. 153, 187.] It was further provided: "In the event that the corporation shall fail to redeem" any series at the time and place specified "the holders thereof shall have the right to enforce payment of the par value of said stock so agreed to be redeemed, together with the amount of any unpaid, accrued or accumulated dividends thereon, the same as any unconditional claim or debt against the corporation." [R. 153, 187.] It was further provided: "In the event of any liquidation, dissolution or winding up of the corporation, whether voluntary or involuntary," the holders of said securities "shall be entitled, before any distribution shall be made to the holders of the common stock, to be paid out of the surplus

profits arising from the business of this corporation, and then remaining intact, or in case such profits shall be insufficient, then from the general assets of this corporation. an amount equal to the par value thereof plus said fixed redemption premium, plus all unpaid, accrued, or accumulated dividends thereon." [R. 151, 185.]

At the time said securities were issued petitioner had a lease agreement with Pacific Southwest Trust and Savings Bank whereby said bank was obligated to pay as rental a sum which, with the other income of petitioner, would be sufficient to pay all of petitioner's operating expenses, the so-called dividends on petitioner's cumulative preferred serial stock, interest on petitioner's mortgage bonds and the sums necessary to redeem said securities and bonds at maturity. [R. 140, 176.]

The holders of said securities had no voting rights or rights to participate in the management of the corporation except in case of default in payment of the so-called dividends and the continuance of such default for a period of ninety days, in which event the holders of said securities had exclusive voting rights until said default was cured. [R. 154, 188.]

Petitioner's said securities were dealt in, in "over-the-counter" transactions and accrued dividends, prior to actual declaration thereof, were generally taken into consideration in substantially the same manner and to the same extent as accrued interest upon bonds is taken into consideration upon purchase or sale. [R. 39.]

During the year 1936 petitioner made payments of so-called dividends to the holders of its 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock in the amounts of $65,300.63 and $55,000.00,

respectively. [R. 140, 141.] During the year 1937 petitioner made payments of so-called dividends to the holders of its 5½% Cumulative Preferred Serial Stock in the amount of $41,250.00. [R. 141.]

Additional Facts Pertaining to Discount at Which Securities Were Issued.

Petitioner's securities designated 5½% Cumulative Preferred Serial Stock were issued and sold at discounts. It is stipulated that

> "If the discount at which said securities were sold was a deductible expense it was an expense which it was proper to amortize and deduct over the life of said securities and $1,833.26 of said discount expense was properly allocable to the year 1936 and $31,275.39 of said discount expense was properly allocable to the year 1937." [R. 141.]

Additional Facts Pertaining to Premiums Paid on Redemption.

During the year 1936 petitioner redeemed and retired all of its then outstanding securities designated 6½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of $182,025.00. [R. 142.]

During the year 1937 petitioner redeemed and retired all of its then outstanding securities designated 5½% Cumulative Preferred Serial Stock for the face value thereof plus a total premium of $20,000.00. [R. 142.]

Facts Pertaining to Tax Returns, Payment of Tax and Claim for Refund.

In its income tax return for 1937 petitioner took deductions for the so-called dividends paid to its security holders as interest paid on indebtedness and also took deductions for the discount expense and premiums paid. [R. 144.] In its income tax return for 1936 petitioner did not take deductions for said expenses but claimed the right to deductions for the so-called dividends as interest paid, discount expense and premiums paid in a claim for refund duly filed. [R. 22.] Respondent refused to allow said deductions for either year on the ground that petitioner's securities were preferred stocks. [R. 21.]

Petitioner filed its income tax return for the year 1936 on March 15, 1937, and paid the tax shown thereon in the amount of $83,251.08 in installments as follows: $20,812.77 on March 15, 1937, and like amounts on June 12, September 13 and December 13, 1937. [R. 143.] On March 6, 1940, petitioner duly filed its claim for refund of income taxes overpaid by it for the year 1936 in the amount of $53,900.53. [R. 144.] On May 22, 1940, petitioner paid to the Collector of Internal Revenue for the Sixth District of California the deficiencies in income taxes proposed for the years 1936 and 1937 and herein contested. Said payments were as follows: $842.75 tax, $161.09 interest, or a total payment of $1,003.84 for the year 1936, and $13,878.81 tax, $1,820.21 interest, or a total payment of $15,699.02 for the year 1937. [R. 145.]

Decisions of Board of Tax Appeals and Circuit Court of Appeals.

The Board of Tax Appeals upheld the action of respondent on the ground that the securities in question were preferred stocks and the Circuit Court of Appeals affirmed the decision of the Board. From the opinions below it is apparent that both the Board and the Circuit Court gave no weight to the terms and conditions of the securities and the obligations imposed upon petitioner but based their decisions entirely upon the names used to describe the securities and the formal manner in which the securities and payments were handled.

Questions Presented.

1. Whether the terms and conditions of a security or the names used to describe the security and payments thereon are controlling in determining whether a particular security represents indebtedness and whether the payments made to the holders thereof are interest payments on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

2. Whether a security which imposes a definite and legally enforceable obligation upon the issuing corporation to pay the par value thereof and fixed annual percentage payments payable currently out of surplus or net profits but on or before a specified maturity date, regardless of earnings or profits, is a debt and the payments are interest even though the security is named "stock" and the payments are named "dividends".

3. Whether petitioner was indebted to the holders of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock and whether the so-called dividends paid to the holders thereof were in fact interest payments on indebtedness.

4. Whether petitioner was entitled to deductions for 1936 and 1937 for a portion of the discount at which its securities designated 5½% Cumulative Preferred Serial Stock were issued and sold.

5. Whether petitioner was entitled to deductions in 1936 and 1937 for the amounts paid as premiums upon the retirement of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock.

Specification of Errors to Be Urged.

The Circuit Court of Appeals erred:

(1) In basing its determination of the nature of petitioner's securities upon the names used and the manner in which said securities were treated instead of upon the basic terms and conditions of the securities.

(2) In determining that petitioner's securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock did not represent indebtedness of petitioner to the holders of said securities.

(3) In determining that the so-called dividends paid by petitioner to the holders of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock were not interest paid

on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936.

(4) In determining that petitioner was not entitled to deductions for the years 1936 and 1937 for the portions of the discount at which its securities designated 5½% Cumulative Preferred Serial Stock were sold which were allocable to the years 1936 and 1937.

(5) In determining that petitioner was not entitled to deductions for the years 1936 and 1937 for the premiums paid by petitioner during said years upon the redemption of its securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock.

(6) In affirming the decision of the Board of Tax Appeals herein.

Reasons Relied on for the Allowance of the Writ.

1. The decision of the Circuit Court of Appeals herein is in conflict in principle with decisions of other Circuit Courts of Appeals.

2. The Circuit Court of Appeals has decided an important question of federal tax law which has not been but should be settled by this Court.

BRIEF IN SUPPORT OF PETITION.

1. The Decision of the Circuit Court of Appeals Herein Is in Conflict With Decisions of Other Circuit Courts of Appeals.

The basic issue presented to the Court below was whether petitioner's securities designated 6½% Cumulative Preferred Serial Stock and 5½% Cumulative Preferred Serial Stock represented indebtedness of petitioner to the holders thereof and whether the so-called dividends paid to the holders of said securities were in fact interest payments on indebtedness within the meaning of Section 23(b) of the Revenue Act of 1936. From the opinion of the Circuit Court [R. 213] it appears that its decision that said securities did not represent indebtedness and that the payments were not interest was based upon the names used to describe the securities and the payments and upon the manner in which the securities were treated and the payments were made instead of upon the basic terms and conditions of the securities themselves.

The same question has been presented to other Circuit Courts of Appeals and to the Circuit Court of Appeals for the Ninth Circuit with regard to other securities and the courts have repeatedly stated that the true character of a security is to be determined from the terms and conditions of the contract between the parties and not from the names used by the parties to describe the securities or the payments made thereon.

Brown-Rogers-Dixson Co. v. Commissioner, (CCA-4, 1941) 122 F. (2d) 347;

Helvering v. Richmond F. & P. R. Co. (CCA-4, 1937), 90 F. (2d) 971;

Commissioner v. J. M. Bray Co. (CCA-5, 1942), 126 F. (2d) 612;

United States v. South Georgia Ry. Co. (CCA-5, 1939), 107 F. (2d) 3;

Commissioner v. Schmoll Fils Association, Inc. (CCA-2, 1940), 110 F. (2d) 611.

While each case has been decided upon its own facts, heretofore in each case the determining factor has been whether under the terms and conditions of the security or other contract the corporation had a definite and enforceable obligation to repay the principal sum and to pay a specified return on the investment, regardless of earnings or profits and on or before a definite date determined in advance.

Where such obligations existed it has been held that the security represented indebtedness and that the payments were interest, regardless of the names used.

Commissioner v. J. M. Bray Co. (supra);

Helvering v. Richmond F. & P. R. Co., (supra);

Commissioner v. O. P. P. Holding Co. (CCA-2, 1935) 76 F. (2d) 11;

Arthur R. Jones Syndicate v. Commissioner (CCA-7, 1927) 23 F. (2d) 833;

See also,

Commisisoner v. Palmer, Stacy-Merrill, Inc. (CCA-9, 1940) 111 F. (2d) 809;

Commissioner v. Proctor Shop, Inc. (CCA-9, 1936) 82 F. (2d) 792.

Where such obligations did not exist it has been held that the security did not represent indebtedness and that

the payments were not interest, regardless of the names used.

Commissioner v. Schmoll Fils Association, Inc. (supra);

Brown - Rogers - Dixson Co. v. Commissioner (supra);

United States v. South Georgia Ry. Co. (supra).

In the case at bar, under the specific terms of the securities petitioner had the liabilities and obligations which under the above stated rule establish a debtor-creditor relationship. Petitioner had an enforceable obligation to redeem the securities at the par value thereof on or before the specified maturity dates. [R. 153.] Petitioner also was required to pay the specified dividends (and no more) currently from earnings but from general assets, if necessary, on the specified maturity dates. [R. 153.] The only thing in petitioner's securities which was inconsistent with indebtedness was the names used. In the concurring opinion Judge Healy frankly states—"If they had been denominated 'bonds' rather than preferred stocks, I apprehend that nobody would contend that they were not true evidences of debt or that the returns paid thereon were anything other than interest." [R. 222.]

Judge Healy also states that he is unable to distinguish the present case on principle from *Commissioner v. Palmer, Stacy-Merrill, Inc.*, 111 F. (2d) 809 and *Commissioner v. Proctor Shop, Inc.*, 82 F. (2d) 792. [R. 221.] The decision in *Commissioner v. Proctor Shop, Inc. (supra)* was based primarily upon *Arthur R. Jones Syndicate v. Commissioner* (CCA-7, 1927) 23 F. (2d) 833. Judge Healy's statements indicate that he considered the decision to be a departure from the rule previously followed.

While the majority opinion does not specifically so state, it is apparent therefrom that the decision is based upon the names used and other incidental features and the manner in which the securities were treated, without regard to the basic terms and conditions of the securities.

It is respectfully submitted that the principle of the decision below is in direct conflict with the principle of the decisions of the other Circuit Courts of Appeals cited above.

The facts in the case at bar are quite similar to the facts in *Meridian & Thirteenth Realty Company v. Commissioner*, 44 B. T. A. 865, now pending on appeal before the Circuit Court of Appeals for the Seventh Circuit. In that case securities called stock were held to be indebtedness and payments called dividends were held to be interest. The terms of petitioner's securities, however, complied more strictly to the requirements of a debt in at least one respect than did the terms of the security in the *Meridian* case. Petitioner's securities provided for the enforcement of redemption and the payment of accumulated dividends upon maturity, the same as any unconditional claim or debt against the corporation, whereas in the *Meridian* case the holders of the securities could enforce redemption only by liquidation of the corporation. If the decision in that case is affirmed there will be a direct conflict between the two circuit courts upon almost identical facts.

In his brief on appeal in *Commissioner v. Meridian & Thirteenth Realty Company* (CCA-7, Docket # 7978) the Commissioner makes the following statement with regard to the two cases:

> "The Board itself has cast doubt upon its decision in the instant case, by its subsequent decision in *Pacific Southwest Realty Co. v. Commissioner*, 45 B. T.

A. 426, now pending on appeal before the Circuit Court of Appeals for the Ninth Circuit. In its opinion in that case, the Board attempted to distinguish its decision here. We submit, however, that the effort is not convincing. In fact, we think it will appear from the discussion to follow that there was greater warrant for finding an indebtedness in the *Pacific Realty* case than there was in the instant case."

Also, in the case of *United States v. Title Guarantee & Trust Co.*, now pending on appeal before the Circuit Court of Appeals for the Sixth Circuit, it appears from the opinion of the District Court that the facts are very similar to the facts in the case at bar. (*Title Guarantee & Trust Co. v. United States* (D. C. Ohio), June 25, 1941, Opinion reported in 1941 Prentice-Hall Federal Tax Service, Para. 62824; 1941 CCH Federal Tax Service, Para. 9597.) In that case the District Court held securities called preferred stock to be indebtedness and payments thereon called dividends to be interest. If that decision is affirmed on appeal there will be direct conflict with the decision of the Circuit Court herein.

Similar questions are also involved in appeals now pending before the Circuit Courts for the Fifth Circuit and the Third Circuit. *Parisian, Inc. v. Commissioner* (B. T. A. Memo. Op. Feb. 2, 1942) now pending on appeal before the Circuit Court of Appeals for the Fifth Circuit. *First Mortgage Corp. of Philadelphia v. Commissioner* (B. T. A. Memo Op. Mar. 12, 1942) now pending on appeal before the Circuit Court of Appeals for the Third Circuit.

Petitioner respectfully submits that the decision and opinion below create a conflict in principle with decisions of other Circuit Courts of Appeals which should be settled by this Court.

2. The Circuit Court of Appeals Has Decided an Important Question of Federal Tax Law Which Has Not Been But Should Be Settled by This Court.

Although the question of what constitutes indebtedness and interest on indebtedness within the meaning of Section 23(b) of the Internal Revenue Code and the corresponding sections of the prior Revenue Acts has been considered by the Board of Tax Appeals and the various federal courts on numerous occasions,* it has never been considered by this Court.

**Title Guarantee & Trust Co. v. United States* (D. C. Ohio, 1941), pending on appeal C.C.A. 6th;

Meridian & Thirteenth Realty Co. v. Commissioner, 44 B. T. A. 865, pending on appeal C.C.A. 7th;

Parisian, Inc. v. Commissioner, B. T. A. Memo, Feb. 2, 1942, pending on appeal C.C.A. 5th;

First Mortgage Corp. of Philadelphia v. Commissioner, B. T. A. Memo, Mar. 12, 1942, pending on appeal C.C.A. 3rd;

Commissioner v. J. M. Bray Co. (C.C.A. 5, 1942), 126 F. (2d) 612;

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Commissioner v. Proctor Shop, Inc. (C.C.A. 9, 1936), 82 F. (2d) 792;

Commissioner v. O. P. P. Holding Co. (C.C.A. 2, 1936), 76 F. (2d) 11;

Arthur R. Jones Syndicate v. Commissioner (C.C.A. 7, 1927), 23 F. (2d) 833.

While most of the decisions have been based upon the terms and conditions of the securities in question or other contract between the parties, some of the decisions have been based upon evidence *aliunde* the contract with regard to the understanding and intention of the parties and in the present case the decision appears to be based upon the names used, the manner in which the securities and payments were treated and an opinion of counsel. No clear and definite rule can be formulated from the decided cases for the determination of whether or not a particular security represents indebtedness and whether particular payments are interest or dividends.

State laws with regard to corporations and corporate securities have been so liberalized and so many securities now issued by corporations have features which are consistent with either stock or indebtedness that it is often difficult to definitely classify a particular security as being a stock or a debt.

The determination of whether a security is a stock or a debt and whether the payments thereon are dividends or interest within the meaning of the federal revenue laws is of great importance, both to the taxpayers in properly preparing their returns and computing their tax liability and to the government in properly administering the tax laws. While most of the decided cases have involved the application of Section 23(b) of the Internal Revenue Code and the corresponding sections of earlier Revenue Acts, the question is also of importance in the administration of

other sections of the law, such as Sections 23(k), 112(b)(2) and 719 of the Internal Revenue Code. Until this Court interprets Section 23(b) of the Internal Revenue Code and determines whether the true nature of a security is to be determined from the names used or from the basic terms and conditions of the securities, it is inevitable that there will be continuous controversy and litigation.

The existing confusion with regard to this question is well illustrated by a comparison of the present case with some of the other decided cases. The facts in the case at bar are identical in all material respects with the facts in three other cases, namely, *Meridian & Thirteenth Realty Company v. Commissioner,* 44 B. T. A. 865 (pending on appeal C. C. A. 7th); *Title Guarantee & Trust Co. v. United States* (D. C. Ohio), June 25, 1941, opinion reported in 1941 Prentice-Hall Federal Tax Service, para. 62824; 1941 C. C. H. Federal Tax Service, para. 9597, (pending on appeal C. C. A. 6th); *Diamond Calk Horse Shoe Co. v. United States* (D. C. Minn., July 19, 1940); opinion reported 1940 Prentice-Hall Federal Tax Service, para. 62919, and 1940 C. C. H. Federal Tax Service, para. 9641 (appeal dismissed—C. C. A. 8, 116 F. (2d) 284). In the mentioned cases the Board and the District Courts held securities called stock to be indebtedness and payments thereon called dividends to be interest payments primarily on the ground that the securities carried a definite obligation to repay the principal sum and the fixed dividends on or before a specified maturity date.

In view of the importance to the proper administration of the federal revenue laws of the question of what constitutes indebtedness and interest paid on indebtedness within the meaning of Section 23(b) and other sections of the Internal Revenue Code, and the further question of what are the essential features of an indebtedness, it is respectfully submitted that the present case involves important questions of federal law which have not been but should be settled by this Court.

It is respectfully submitted that this petition should be granted.

JOHN B. MILLIKEN,
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Of Counsel:
CLAUDE I. PARKER,
BAYLEY KOHLMEIER,

August, 1942.

Due service of the within petition and brief is hereby acknowledged this.....day of August, A. D. 1942.

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Counsel for Respondent.

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 341

PACIFIC SOUTHWEST REALTY COMPANY, A CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 37–65) is reported in 45 B. T. A. 426. The opinion of the United States Circuit Court of Appeals (R. 213–222) is reported in 128 F. 2d 815.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 8, 1942. (R. 223.) The petition for a writ of certiorari was filed August 27,

1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether dividends paid by the taxpayer on its preferred stock are deductible as "interest paid on indebtedness" within the terms of Section 23 (b) of the Revenue Act of 1936.

2. Whether the discounts at which the taxpayer sold its preferred stock or the premiums paid in connection with the sale and redemption of its preferred stock in the taxable years were expenses that could be deducted, or amortized over the life of the stock. This depends upon whether the preferred stock represented "bonds" within the terms of Article 22 (a)–18 of Treasury Regulations 94.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1936, c. 690, 49 Stat. 1648:

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * *

means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year * * *.

* * * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)–18. *Sale and purchase by corporation of its bonds.*—(1) (*a*) If bonds are issued by a corporation at their face value, the corporation realizes no gain or loss. (*b*) If the corporation purchases any of such bonds at a price in excess of the issuing price or face value, the excess of the purchase price over the issuing price or face value is a deductible expense for the taxable year. * * *

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ART. 23 (b)–1. *Interest.*— * * *

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So-called interest on preferred stock, which is in reality a dividend thereon, can not be deducted in computing net income. (See, however, article 22 (a)–18 and section 121.)

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STATEMENT

The facts, most of which were stipulated, and as found by the Board of Tax Appeals, may be summarized as follows:

In conformity with its articles of incorporation petitioner issued and sold two series of "Cumu-

lative Preferred Serial Stock." (R. 37, 42–43.) The certificates stated that they were redeemable at par, plus all unpaid, accrued, and accumulated dividends, and that the holders should have the right to enforce payment the same as on any unconditional claim or debt against the corporation. (R. 41–42.) The articles also authorized the corporation to issue bonds, though the total indebtedness of the corporation could not exceed 50 per cent of the appraised value of the property subject thereto. (R. 40–41.) First mortgage bonds in an amount substantially equivalent to the face amount of the preferred stock were issued and sold at about the same time that the stock was issued. (R. 53–54.) The stock was represented to be free from the personal property tax of the state and free from the normal federal income tax. (R. 46, 55.) The periodic payments on the stock, while cumulative, were to be made periodically only if there were profits, were denominated "dividends" and no payments were ever made except following the declaration of a dividend. (R. 58.) If dividends on the preferred stock remained delinquent more than ninety days, the voting rights vested exclusively in the preferred stockholders until all arrears in dividends were paid. (R. 42, 192.)

During the year 1936 all of petitioner's 5½ per cent preferred shares of the par value of $1,000,000 were outstanding. All of them were redeemed and retired during the year 1937. Dur-

ing the years 1936 and 1937 petitioner made payments to the holders of those securities at the rate of 5½ per cent of the par value, or $55,000 during the year 1936 and $41,250 during the year 1937. (R. 46.)

The 5½ per cent preferred stock was sold by petitioner at discounts of $3 and $5 per $100 par value, the discount aggregating $46,858. The parties stipulated that if the discount at which the securities were sold was a deductible expense, it was an expense which it was proper to amortize and deduct over the life of the securities and $1,833.26 of that discount expense was properly allocable to the year 1936 and $31,275.39 was properly allocable to the year 1937. (R. 47.)

During the year 1936 petitioner redeemed and retired all of its then outstanding 6½ per cent preferred stock for the face value thereof ($3,766,500) plus a total premium of $182,025. During the year 1937 it redeemed and retired all of its then outstanding 5½ per cent preferred stock for the face value thereof ($1,000,000) plus a total premium of $20,000. (R. 47.)

In its income tax return for the year 1936 petitioner failed to take deductions for the payments made on its securities designated 6½ per cent and 5½ per cent preferred stock, failed to take deduction for the portion of the discounts at which its securities designated 5½ per cent preferred stock were issued and sold which was allocable to the year 1936, and failed to take a

deduction for the premium paid upon the redemption of its securities designated 6½ per cent preferred stock. (R. 48.)

In redetermining petitioner's income for the year 1936 following the filing of a refund claim by the petitioner, the Commissioner did not allow any deductions for the payments made by petitioner during the year on its securities designated 6½ per cent preferred stock and 5½ per cent preferred stock, did not allow a deduction for any portion of the discount at which petitioner's securities designated 5½ per cent preferred stock were issued, and did not allow a deduction for the premium paid by petitioner upon the redemption of its securities designated 6½ per cent preferred stock. (R. 49.)

In its income tax return for the year 1937 petitioner deducted as interest paid the payments made on its securities designated 5½ per cent preferred stock in the amount of $41,250, deducted the sum of $31,275.39 as the portion of the discount at which the securities were issued and sold which was properly allocable to the year 1937, and deducted the premium paid in the amount of $20,000 upon the redemption of the securities. The Commissioner refused to allow these deductions. (R. 50.)

The Board of Tax Appeals upheld the action of the Commissioner (R. 65), and the court below, with Judge Healy concurring in a separate opinion, affirmed the judgment of the Board of Tax Appeals (R. 223).

ARGUMENT

Whether preferred stock of a corporation may be said to represent "indebtedness" within the meaning of Section 23 (b) of the Revenue Act of 1936, *supra,* so that the corporation is entitled to a deduction for interest in the amount of dividends paid, depends upon the facts of each case. *Commissioner* v. *O. P. P. Holding Corp.,* 76 F. (2d) 11, 12 (C. C. A. 2d); *Commissioner* v. *Schmoll Fils Associated,* 110 F. (2d) 611, 613 (C. C. A. 2d). Petitioner admits that this is true (Pet. 12), but asserts a conflict of decisions, contending that the reason the court below held the payments involved herein were dividends on stock, and not interest, was simply that the parties called them dividends. (Pet. 11, 14.) However, the opinion of the court below laid great weight on the facts that the dividends were payable only when declared (R. 214, 219, 220), that they were payable only out of profits (R. 217, 219), that if they were delinquent for 90 days the preferred shareholders succeeded to the exclusive voting power so long as any dividends were in arrears (R. 214), and that at the time the securities were issued the corporation declared its understanding that payments on them would be dividends and not interest (R. 219). It is clear that these facts prompted the decision below as much as, if not more than, the fact that the payments were called dividends. Petitioner's statement of the ground on which the decision below

rests is apparently based on the special concurring opinion of Judge Healy rather than on the opinion of the court.

The securities in the instant case are hybrids. Petitioner points out (Pet. 17) that under the progressively more liberal provisions of state corporation laws more of these hybrids are appearing with features both of stock and of obligations of debt, and urges that this constitutes a reason why this Court should review this case. There is, however, no reason to believe that by such review the Court can lay down rules which will be an answer to the problems of classification of all such hybrids. One may safely assume that a share of stock cannot be converted into an indebtedness for the purposes of Section 23 (b) by the addition of one feature of an indebtedness to what is otherwise a share of stock.[1] Since this is so, the classification

[1] The attempt to give controlling effect to one feature of the securities, namely the obligation to pay principal and a specified return on or before a fixed date, is not supported by the cases cited (Pet. 12). In *Commissioner* v. *J. N. Bray Co.*, 126 F. (2d) 612 (C. C. A. 5th), no declaration by the directors was required for periodic payments; in *Helvering* v. *Richmond, F. & P. R. Co.*, 90 F .(2d) 971 (C. C. A. 4th), the payments were to be made irrespective of earnings, and default entitled the holders to foreclose; in *Commissioner* v. *O. P. P. Holding Corp.*, 76 F. (2d) 11 (C. C. A. 2d), the payments were treated by the corporation as interest on debentures and did not depend on earnings; in *Arthur R. Jones Syndicate* v. *Commissioner*, 23 F. (2d) 833 (C. C. A. 7th), the securities evidenced a loan for a year, the "dividend" being payable in any event and the transaction constituting an effort to avoid the usury law.

of one of these hybrids is a process of weighing the various features which point to its being an indebtedness against the features which point to its being stock to determine which features predominate.

The decision below, which affirmed the Board, correctly applied the principles which have been developed in this field. It weighed the features indicating stock against those indicating indebtedness and properly concluded that the former predominated. These securities entitled the holders to "dividends" from surplus when declared by the directors and entitled them to exclusive voting rights if the dividends fell into arrears. A decision that such securities were shares of stock and not obligations of debt is hardly surprising, particularly since petitioner itself, from the date of their issuance until 1937, treated them as shares of stock.

Petitioner suggests that a conflict of decisions may be anticipated because cases similar to this one are now pending in other circuits.[2] Those cases, however, all differ on their facts from this case, and in any event an assertion of conflict among the circuits is premature.

The second question in the case is whether discounts at which the taxpayer sold its preferred stock or the premiums paid in connection with the sale and redemption of its preferred stock in the

[2] None of those cases has been argued.

taxable years were expenses that could be deducted or amortized over the life of the stock. This question depends upon whether the preferred stock issued by the taxpayer constitutes "bonds" within the meaning of Article 22 (a)–18 of Treasury Regulations 94, *supra*. It is apparent that the answer to the first question in this case controls the answer to the second.

CONCLUSION

The decision of the court below is correct and there is no conflict of decisions. The case is not of general importance because it turns upon its particular facts. The petition for a writ of certiorari should be denied.

Respectfully submitted.

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